What's Next for the Dollar?

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ABSTRACT

The real trade weighted value of the dollar fell 11 percent against the Federal Reserve Bank's index of major currencies during the 12 months through May 2011 and 31 percent during the past ten years. Four strong market forces are likely to cause further declines over the next several years: a portfolio rebalancing by major international investors who regard their portfolios as overweight dollars, the large US current account deficit, a Chinese policy to raise consumption, and interest rate differences that make dollar investments less attractive.

A declining dollar could have a powerful positive effect on the short-run performance of the American economy by raising exports (now more than $1.3 trillion) and inducing American consumers to shift from imports to American made products and services. Without a boost to demand from an increase in net exports, the U.S. recovery is likely to remain weak and could run out of steam.

There are of course also negative effects of a falling dollar: reducing the real value of any given level of personal incomes by raising the cost to households of the imported products that they consume and creating inflationary pressures as import prices rise.

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What's Next for the Dollar?

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When it comes to the value of the dollar, the official mantra of the US government is that "a strong dollar is good for America." Official "mantra" but not official policy. Neither the U.S. government nor the Federal Reserve does anything to strengthen the dollar or to prevent it from falling.

A more accurate description of American policy is to have a strong dollar at home and a competitive dollar abroad. A strong dollar at home means a low inflation rate that maintains the purchasing power of the dollar domestically. This is clearly the goal of the Federal Reserve and one that has been achieved reasonably well over the past three decades with an average inflation rate of three percent.

In contrast, the competitiveness of the dollar abroad requires a decline in the trade weighted value of the dollar to make U.S. exports more attractive to foreign buyers and foreign goods less attractive to American consumers by reducing the relative price of American goods and services. The dollar has in fact fallen over the past several decades and fallen sharply in the past year despite the mantra favoring a strong dollar. And the fall in the international value of the dollar has not prevented maintaining the low inflation rate at home.

Here are the facts: In the 12 months through May of this year, the real trade weighted value of the dollar fell 10.6 percent against the Federal Reserve Bank's index of major currencies and 9.1 percent against the broader index of currencies that is also calculated by the Federal Reserve.

The government's willingness to allow this rapid decline of the dollar – and perhaps even to encourage it by urging the Chinese to cause the dollar to depreciate relative to the renminbi and by the Fed's policy of quantitative easing – shows that U.S. dollar policy is more about achieving a competitive dollar than about a strong international value of the dollar.

The same is true if we look at the dollar's performance over a longer period. Over the past ten years, the real trade weighted value of the dollar fell 31 percent against the index of major currencies and 26 percent against the Federal Reserve's broader index of currencies.

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The Future

But what of the future? There are four major reasons why the dollar is likely to continue falling for at least the next few years. Note that I am not advocating policies to make that happen. I am just looking at the fundamental economic forces that I believe will cause that continued decline to occur.

The primary reason is that major investors around the world want fewer dollars in their portfolios. The major fund managers in Asia, in the Middle East, and elsewhere who are responsible for sovereign wealth funds and for national pension funds generally believe that they are overweight dollars and want to diversify their portfolios away from that overconcentration on dollar securities.

Those governments accumulated large amounts of foreign exchange as a result of trade surpluses. In some countries this was the caused by undervalued exchange rates that led to increased exports and reduced imports. In the oil producing countries, it was the result of the rapid rise in the price of oil. The relevant officials in those countries initially regarded these foreign exchange holdings as traditional reserves to be held as a way of bridging any future gap between the cost of imports and the country's export earnings.

Eventually, however, these countries recognized that they did not need such large amounts of foreign exchange to bridge the temporary import-export gaps that might arise in the future. Korea, Taiwan, Singapore and others with more than $200 billion in foreign exchange each came to understand that only a small portion of that was needed for the traditional purpose of foreign exchange reserves. That is even more relevant for the major oil producing countries and for China with $3 trillion of foreign exchange.

Once they recognized that these were really important national investment funds, they asked themselves in what currencies they should be held, in what asset classes, in what maturities. The traditional investment in short term U.S. treasury bills ceased to make sense.

So they began shifting out of the dollar and into other currencies. The primary currency that they bought was the euro. Although funds also went into the Swiss franc, the Australian dollar, the Norwegian kroner and other smaller currencies, only the market for euro bonds was large enough to absorb substantial shifts of funds. The result of this portfolio shift was to reduce the value of the dollar relative to the euro and to the other currencies.

This diversification into the euro was temporarily halted by the start of the crisis in Greece and the other peripheral countries. The result was a fall of the euro relative to the dollar and other currencies. But after a while these investors realized that the problem of Greece and the other peripherals was not a problem of the euro as such but of the individual countries with excessive national debts and deficits. They

concluded correctly that these problems should be reflected in the interest rate spreads and in the cost of credit default swaps rather than in the value of the euro.

So the euro began rising again, increasing from about $1.35 per euro to $1.50. The more recent confusion and uncertainty about the resolution of Greece's need for additional credit and about the more remote possibility of defaults in Spain and Italy temporarily reduced the euro back to about $1.40. But, in my judgment, it will start rising again. The recent reports that China has invested some three-fourths of its increased foreign assets this year in euros is consistent with this pattern of renewed portfolio reallocation.

Predicting that the euro will continue to rise may seem to ignore the very high prices that anyone who now travels to France or Germany must pay. It is easy to conclude that the euro is fully valued and not likely to increase further. This casual empiricism is supported by official government calculations of purchasing power comparisons. But both bits of evidence are misleading. What matters are the prices that drive current account balances. The prices paid by tourists are only a small part of the relevant price of tradeables. And the price calculations of government officials do not accurately reflect the quality differences as judged by consumers. So while government statisticians may believe that German cars are expensive relative to American cars, consumers around the world are clearly willing to buy German luxury cars at their existing high prices. That's one of the reasons why Germany has a current account surplus of nearly $200 billion. In short, the apparent high price of European goods and services is not a reason why the dollar will not continue to fall relative to the European currencies.

The second reason that the dollar will decline is the enormous size of the U.S. current account deficit. During the last 12 months the merchandise trade deficit was $680 billion (more than four percent of US GDP) and the current account deficit was $470 billion. Shrinking that large current account deficit can only be done by reducing the value of the dollar relative to the currencies of other countries.

The United States is a major exporter with exports last year of more than $1.3 trillion. A more competitive dollar would increase the volume of exports and reduce the volume of imports.

Which currencies are able to rise relative to the dollar, leading to a decline of the US current account deficit? The euro is again the natural candidate. The Eurozone represents a large capital market and has a current account deficit of only one-half a percent of the Eurozone's GDP. Other countries that have large current account surpluses, implying that they have the room to absorb the effect of a currency increase, include China with a current account surplus of more than $300 billion, Japan with a current account surplus of nearly $200 billion (causing the yen to rise despite the problems of the Japanese economy), Switzerland with a current account surplus of $80 billion despite the strength of the Swiss franc, and the key Asian

countries – Singapore, Taiwan and South Korea—that together have a current account surplus of more than $100 billion.

In short, the large US current account deficit and the corresponding large current account surpluses elsewhere provide a natural pressure for the dollar to decline relative to those other currencies.

The third reason that the trade weighted value of the dollar will decline over the next few years is China's new goal of increasing consumer spending in China. Although China's rapid economic growth has led to a substantial increase in the standard of living of Chinese households, the level of consumer spending has not increased as rapidly as China's overall GDP. The new twelfth five year plan calls for a rise in consumption as a share of GDP, plus increased government spending on consumer services like health care and education.

This in turn will imply a decline in China's enormous national saving rate, estimated to be over 40 percent of China's GDP. Since any country's current account surplus is the difference between its national saving and its national investment (i.e., investment in business structures and equipment and in housing), China's very high saving rate allows it to have both a very high investment rate and a current account surplus of about 3.5 percent of its GDP.

If China's net saving rate falls by just four percent of its GDP, China's current account surplus will end and will change to a current account deficit. An end to its current account surplus would mean that China would no longer be a net buyer of foreign securities. Until now, China has been the largest lender to the United States to finance our current account deficit. If China will no longer be buying dollars in order to invest in dollar bonds, the dollar will fall.

Moreover, if China wants to continue to make real investments in the rest of the world – buying oil in the ground, agricultural land in Africa, businesses in various western countries, etc. – it will have to become a net seller of some of its $3 trillion of foreign securities – primarily dollars -- that it currently owns. That means further downward pressure on the dollar.

Although the fall in the dollar that would result from the reduced Chinese demand for dollars need not mean a fall in the dollar relative to the renminbi, the Chinese government's policies are likely to cause that rise in the renminbi-dollar exchange rate. The renminbi is of course a controlled exchange rate. The government of China has allowed the renminbi to rise relative to the dollar by about 5.5 percent over the past 12 months. But since the dollar was falling during this time relative to the euro, the yen and other currencies, the trade weighted value of the renminbi did not rise over this period.

During the past year, the Chinese government prevented a faster rise of the renminbi relative to the dollar because it wanted to protect Chinese export

manufacturers. But in coming years the rise in spending by Chinese consumers and by the Chinese government will substitute for the reduced value of net exports that occurs as China's current account surplus declines.

The Chinese government has been reassuring its domestic manufacturers that it will not let the renminbi jump sharply as some foreigners have advocated. But it has also made it clear that the renminbi will continue to rise and it has advocated that its manufacturers shift production to products for the domestic market.

The implication of all this is that China can now allow the renminbi to rise more rapidly. There is also a further reason why the Chinese government is now likely to let the renminbi rise faster. The increased domestic spending in China will increase demand and raise inflationary pressures. A stronger renminbi would offset these inflationary pressures in two ways. By increasing the relative cost of Chinese exports, a stronger renminbi will reduce the demand for those products and therefore limit that source of inflation. A stronger renminbi also reduces import costs, including the costs of raw materials that are used in Chinese production.

This brings me to the fourth and final reason to expect the dollar to continue declining over the next few years: the relatively low level of real interest rates in the United States. Because of the weakness of the US economy, the Federal Reserve has set the short-term federal funds rate at near zero and promised to keep it at that level for an extended period of time. Based on this promise of continued low short rates, multiyear rates are also very low. After allowing for current and expected inflation, the implied real rates are negative.

In contrast, the ECB has raised the short-term rate and indicated that it will raise it further. The ECB needs to do this in order to prevent imported inflation from food and energy prices triggering a price-wage spiral in Europe's heavily unionized economy. In the United States, wages are not rising and unions hardly exist. Only 7 percent of private sector workers are unionized. So the real interest gap will widen, making investment in short term eurobonds of Germany or France more attractive than investment in the corresponding US bonds.

In summary, there are four reasons to expect that the dollar will continue to decline relative to the Euro and other major currencies over the next several years: a portfolio rebalancing by investors who regard their portfolios as overweight dollars, a continuing large US current account deficit, a Chinese policy to reduce net exports, and interest rate differences that make dollar investments less attractive.

It is of course impossible to say how fast the dollar will decline. Although it may fall only gradually, it could continue to fall at the 10 percent rate of the past 12 months or even faster if the holders of large dollar investments want to exit their positions to avoid the losses that will result from the dollar's decline.

How likely is that? China is of course reluctant to reduce its dollar position rapidly because of the adverse effect that would have on the dollar-RMB exchange rate. In contrast, smaller countries and private investors could shift from the dollar to other currencies without causing a significant impact on the value of their dollar exchange rates. But if each of these countries – Korea, Taiwan, etc – wants to move before selling by others causes the dollar to decline further, the cumulative effect as they all try to do so could be a sharp decline of the dollar. And if China sees that coming, it might want to move more rapidly to shrink its dollar position.

The Effect of the Dollar Decline

A declining dollar would have a powerful positive effect on the short-run performance of the American economy. A continued decline of the dollar will raise the current annual exports of more than $1.3 trillion and will induce American consumers to shift from imports to American made products and services. Although exports are less than 10 percent of U.S. GDP, more than one third of the increase in US GDP over the past four quarters was accounted for by the increase in exports.

Without a boost to demand from a future increase in net exports, the American recovery is likely to remain weak and could run out of steam, leading to a new downturn of GDP. Although the U.S. recession officially ended in the summer of 2009, the expansion since then has been very weak. In the first three quarters of 2010 GDP grew at an annual rate of just 2.7 percent and more than half of that increase was just inventory accumulation rather than final sales. Although the fourth quarter of last year saw a temporary surge of consumer spending, this improvement of final demand and GDP did not follow through in the current year.

The annualized rate of growth fell from 3.1 percent for the fourth quarter of last year to just 1.9 percent for the first quarter of 2011. Private estimates of monthly GDP by Macroeconomic Advisers indicate that the level of GDP actually fell between December of 2010 and January of 2011, and then fell further in February. March was the only positive month in the first quarter. The data for April, May and June showed renewed weakness with a rising unemployment rate, a sharp fall in employment gains, lower real weekly earnings, reduced real retail sales and industrial production, declines in business and consumer confidence, a continued collapse of housing prices and the first decline in the index of leading indicators since early 2009, before the upturn began. Monthly estimates of GDP fell again in April and May.

So without a dollar decline the outlook for the US economy is very negative. A decline in the value of the dollar can change this significantly. Cutting the US trade deficit from the current level of three percent of GDP by two percentage points of GDP would provide an initial demand stimulus equal to two percent of GDP. This would be more powerful than a comparable size fiscal stimulus and would provide

that stimulus without adding to the national debt. It would also provide more stimulus than anything that the Federal Reserve might do at the current time.

There are of course also negative effects of a falling dollar. The unambiguously adverse effect is to reduce the real value of any given level of personal incomes by raising the cost to households of the imported products that they consume. The magnitude of this effect is substantial but should not be exaggerated. Since imports are only 16 percent of GDP, a 20 percent further fall in the dollar would reduce real incomes by no more than about three percent. Even this overstates the adverse effect of the weaker dollar on real incomes since various imports are either priced in dollars (like oil) or experience adjustments in the foreign currency price as foreign exporters seek to offset the adverse effect of the weaker dollar on their exports.

The other adverse effect of a lower dollar is to create inflationary pressure. Again, the effect is relatively small. A 10 percent annual fall of the dollar would raise the price level and the rate of inflation by less than two percent. Given the state of the labor market, this would only affect the price level and would not be the beginning of a price-wage spiral.

In conclusion, there would be both strong positive effects of a dollar decline on aggregate demand but also adverse effects on real incomes and on the price level. But the decline of the dollar during the next few years is not a matter of choice to be decided by weighing the advantages and disadvantages of a lower dollar. It is something that is likely to happen. If it does, we will see a continuing decline of the dollar and with it a greater hope for a stronger economic recovery.

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